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US Local Government

Local Government GO Pledges Vary Across States

Summary

The general obligation (GO) pledge is the signature promise in the municipal market. Since the Great Depression, local government GO defaults have been rare compared to other types of debt in the capital markets. Indeed, despite the recent spate of high-profile GO defaults, including [Detroit, MI](#) (issuer rating B3 stable), [Jefferson County, AL](#) (issuer rating Ba3 stable) and Harrisburg, PA (unrated), these types of market-shaking events remain the exception.

We recently completed a survey of local government GO pledges in all 50 states. This research is part of a series of reports about the institutional and legal framework in which local governments operate. It builds on our earlier reports [Key Credit Considerations for Municipal Governments in Bankruptcy](#) (January 2012) and [US State Oversight Is Often Credit Positive for Distressed Local Governments, but No Guarantee Against Default](#) (September 2013). Our key conclusions are:

» **Local government GO pledges are not monolithic; they include an unlimited or limited tax pledge, vary among the states, and sometimes vary within a state for different kinds of issuers.**

» **The GO pledge generally includes some combination of four features:**

- A full faith and credit promise to repay debt from all legally available revenue or funds, including property (*ad valorem*) taxes;
- A separate property tax levy dedicated to paying debt service;
- A separation of pledged revenues from operations found in a third-party "lockbox" structure;
- Presence of a statutory provision or judicial ruling showing an intent to secure the GO pledge.

» **Lockbox and statutory protections, found in only a few states, warrant a degree of positive consideration in our local government GO methodology.** The extent of any resulting rating adjustments is necessarily limited, however, because evidence of the practical benefit of these protections in highly stressed situations remains thin and largely untested.

Local government GO pledges vary across states

GO debt is not monolithic. A local government's GO pledge is a contractual promise to repay a debt, but the specific contours of GO pledges depend on state law. GO pledges vary among states and sometimes even within a state, depending on the type of local government and the degree of local discretion to add security features beyond those required by state statute.

The two basic types of GO debt are unlimited and limited *ad valorem* tax pledges. With GO unlimited tax (GOULT) debt, the local government promises to repay its debt from all legally available sources, including raising property taxes by an unlimited amount. In some cases there are restrictions or caps on the government's ability to raise taxes, creating a GO limited tax (GOLT) pledge.

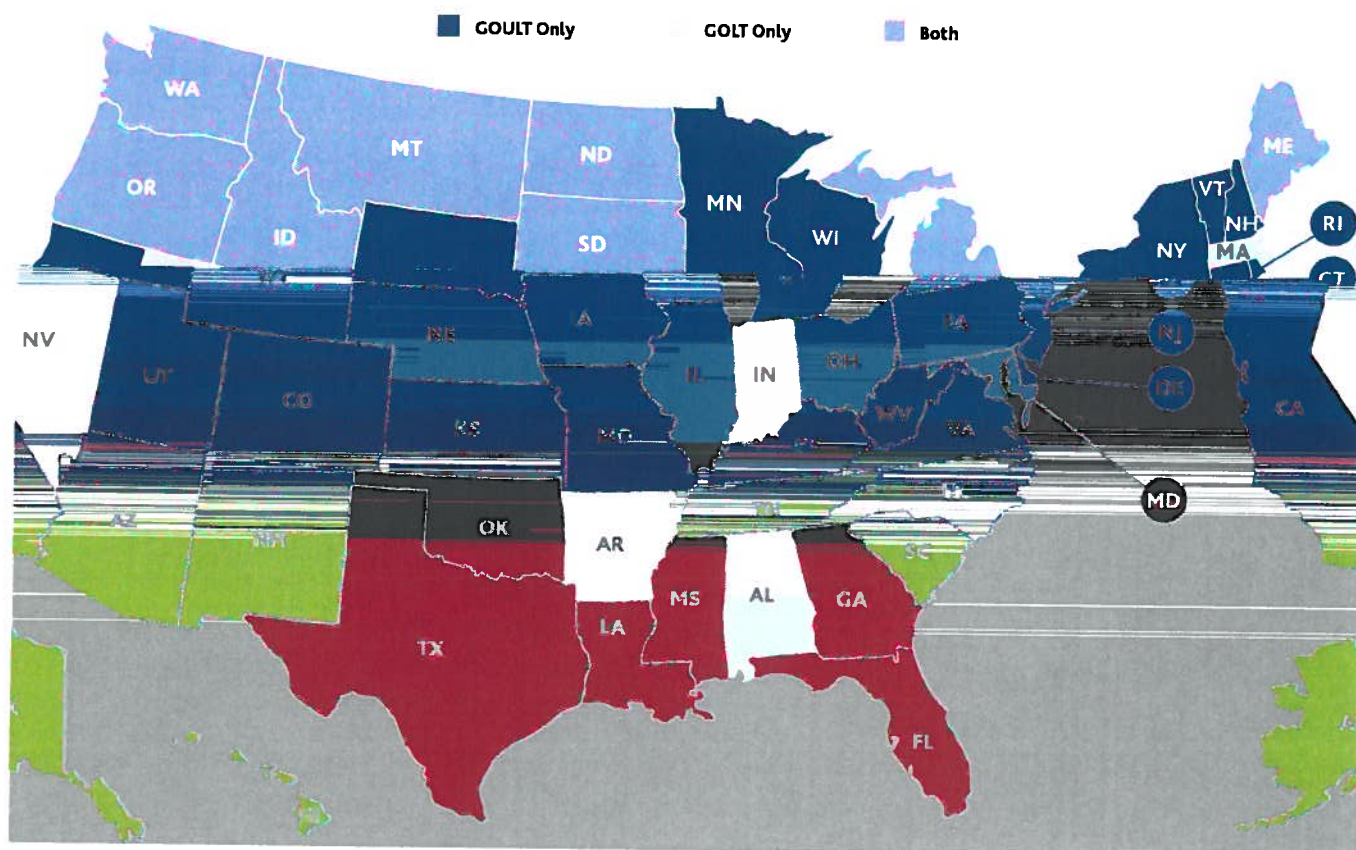
Enforcing the GO Pledge

Outside bankruptcy, when a municipality fails to honor its GO bonds, bondholders can seek to compel the municipality to pay through a *mandamus* action. The court could order the municipality to levy taxes or use available funds for debt service. In bankruptcy, the automatic stay¹ likely prevents such a ruling. Bondholders and creditors generally need to wait for the resolution of their claims through the Chapter 9 process.

The laws of 45 states (90%) authorize local governments to issue GOULT debt. Twenty states have both GOULT, or GOLT debt, depending on various factors such as type of local government, nature of the project or whether voters approved the debt issuance. Five states (10%) have only GOLT debt. Exhibit 1 shows the pledge types across all 50 states for cities, counties and school districts.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Exhibit 1

Most States Have GOULT Pledges

IN – Debt issued before the circuit breaker legislation is technically unlimited tax debt.
 MA – With voter approval, local governments can exclude the debt service levy from levy limits.
 NY – The tax cap that sunsets in 2016 currently makes non-school GO debt limited tax debt.

Source: Moody's Investors Service

Local government GO debt includes four major security features

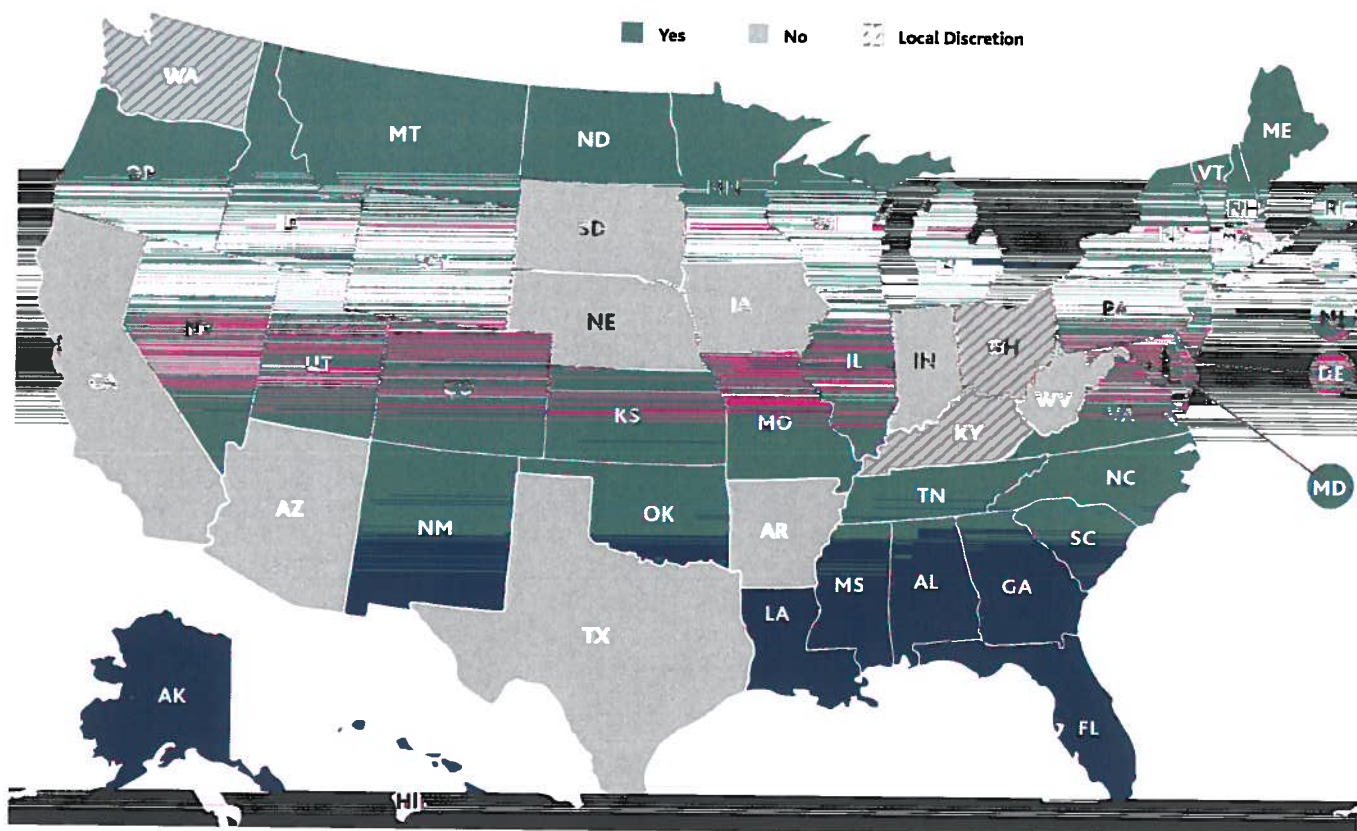
Local government GO pledges generally include some combination of four features (1) a full faith and credit promise; (2) a separate property, or *ad valorem*, tax levy dedicated to pay debt service; (3) the segregation of pledged revenues held apart from the issuer's operating revenues by a third-party "lockbox" mechanism; (4) a state statute that secures the GO pledge.

The following exhibits and commentary reflect Moody's research on the statutory requirements for GO debt in each state. Maps highlight the GOULT pledge if a state has both GOULT and GOLT. Variations within a state, between GOULT and GOLT or among governmental sectors, are noted.

(1) Full faith and credit pledge

"Full faith and credit" is a common legal expression used by local governments to describe a promise to repay debt with all available financial resources, including property taxes. Local government GO debt in 38 states (76%) carry a full faith and credit pledge. While the pledge constitutes a contract, a bankruptcy court is likely to view the pledge as an unsecured claim, since it is nothing more than a bare promise of the local government to repay debt service without collateral behind it. Exhibit 2 shows the states with full faith and credit pledges.

Exhibit 2

Thirty-Eight States Provide a Full Faith and Credit Pledge for Local Government GO Debt

FL – LT debt only carries full faith and credit at the local government's discretion.

IA – LT debt carries full faith and credit, but ULT does not.

KY – Local governments are not required by state law to pledge their full faith and credit but typically do in the local ordinance.

LA, MS – LT debt does not carry full faith and credit pledge.

ND – LT debt and GOULT special assessment debt do not carry full faith and credit pledge.

OH – ULT and LT debt carries full faith and credit pledge if included in local government's authorizing legislation.

WA – Local governments typically pledge full faith and credit but this is not required by law.

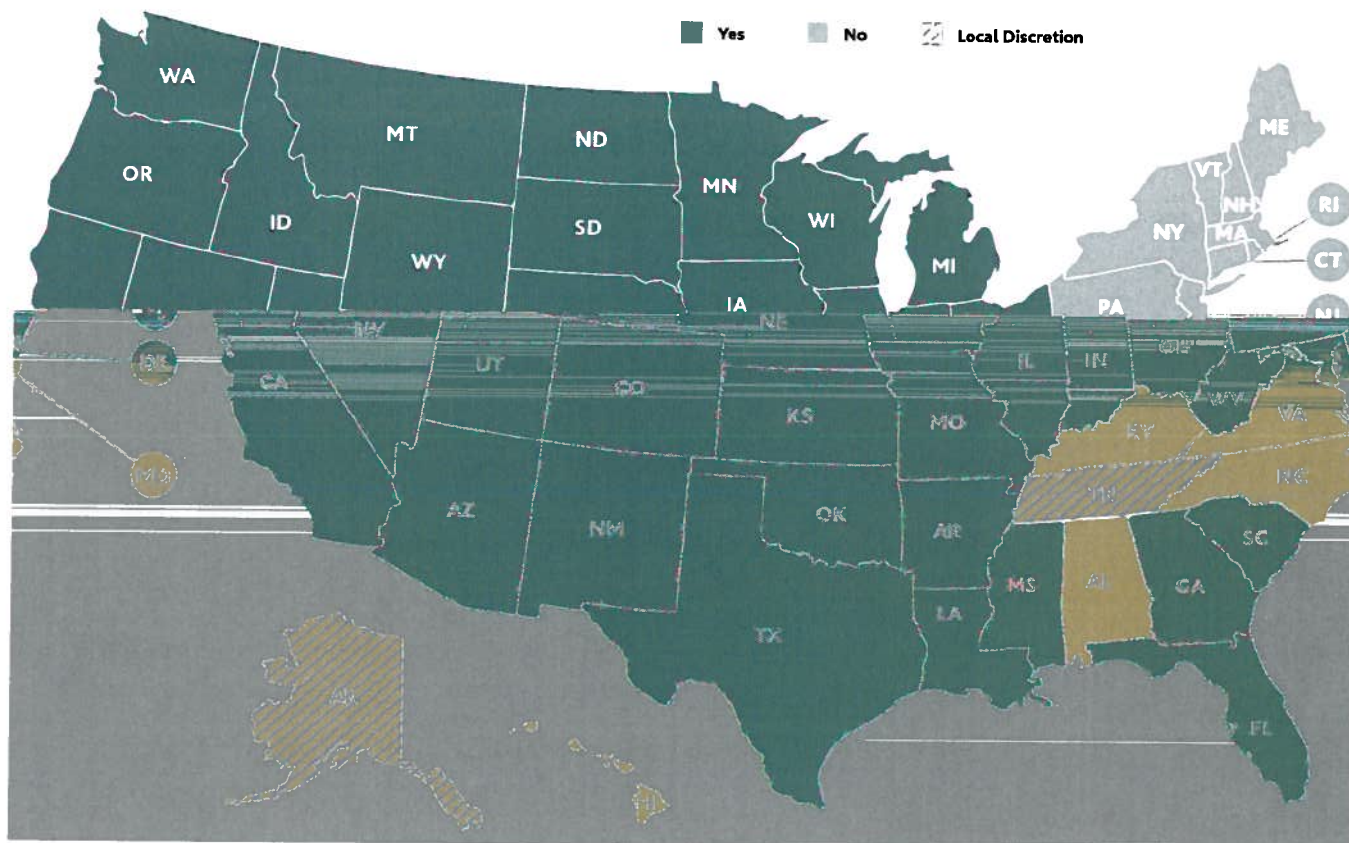
WY – Only counties and school districts pledge full faith and credit.

Source: Moody's Investors Service

(2) Separate ad valorem tax levy dedicated to debt service

Of all the GO pledges, 32 states (64%) have a separate property tax dedicated solely for the repayment of debt service. This is often a voter-approved levy for a particular bond issue or project. An example of this would be a separate property tax appearing on a tax bill for a certain millage (dollars per thousand) rate. The separate tax does not imply a "lockbox," however, because in most of these situations the municipality collects its own taxes and/or maintains control over the funds. The separate nature of the dedicated debt service tax does not by itself enhance investor security. Exhibit 3 shows those states with a separate *ad valorem* tax dedicated for debt service.

Exhibit 3

Thirty-Two States Have a Separate Ad Valorem Tax for GO Debt

GA- Contractual obligations do not have a dedicated levy.

IA - LT debt does not have separate, dedicated levy. Also school district ULT debt supported by physical plant and equipment levy is not separate.

ID, LA, MI, MT, NE, OR, WA - LT debt does not have separate, dedicated levy.

IL - LT debt service extension base debt supported by separate levy, but other LT debt is not

KY - ULT debt supported by separate levy only if all other funds insufficient

NV- Only voter approved LT debt has separate levy. Medium-term LT debt and additionally-secured LT debt do not have a separate levy.

OH- LT debt has separate dedicate levy only if a portion of the inside millage is specifically allocated to debt service in the annual taxing resolution.

Source: Moody's Investors Service

(3) Lockbox structure for taxes that pay GO debt service

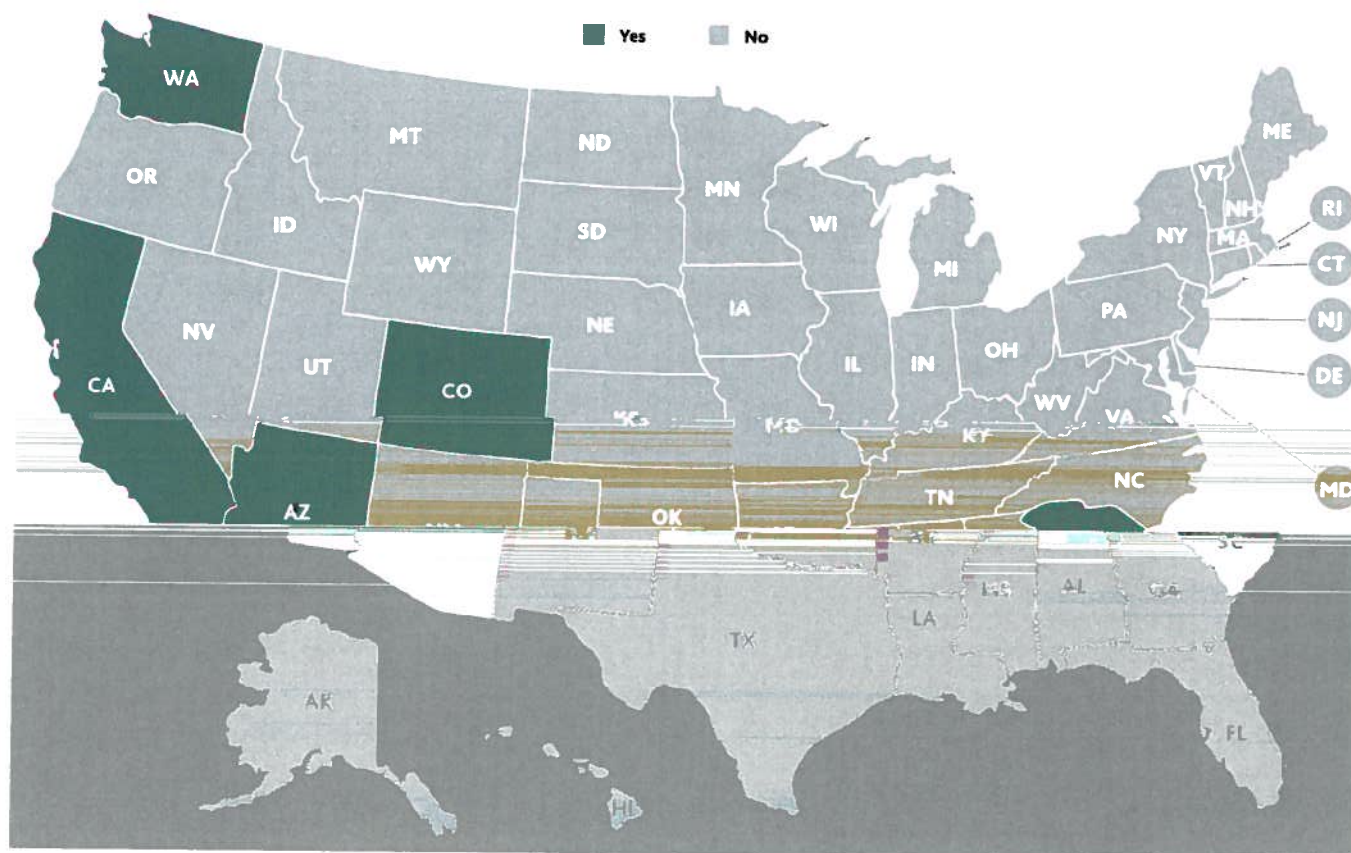
A "lockbox" structure, found in just five states, occurs where a third party, typically another level of government, collects and holds pledged property tax revenue, creating a separation from the issuer's operations and funds. Our definition of lockbox also requires that the third party also remit the debt service payments directly to the paying agent or bondholders on behalf of the issuer, such that no debt service funds flow through the issuer. We regard the lockbox as providing some measure of additional security to investors because the issuer never has possession of the debt service monies.

California (Aa3 stable) offers one example of a lockbox structure as counties collect all property taxes. Counties then remit property taxes to school districts, cities and other local governments. Under California law, property tax rates are capped at 1% of assessed values, unless voters approve GO debt. With voter approval, the tax rate for the repayment of GO debt is not subject to the 1% cap. For school districts and some cities with agreements with a county, instead of remitting the taxes collected for the repayment of GO debt, counties hold back these levies and then make debt service payments to investors, thus preventing the school district or city from having control over these funds.

While we are unaware of a GO lockbox structure being litigated in bankruptcy, the issue has come up in at least one bankruptcy case. In the Vallejo, CA (unrated) bankruptcy, the city ultimately settled with National Public Finance Guarantee Corporation (A3 negative) over whether a state intercept of vehicle licensing fees was property of the city's estate and not subject to the automatic stay. Under the agreement, these revenues continued to flow to the trustee and debt service was not interrupted.

Exhibit 4

Five States Have Lockbox Structures



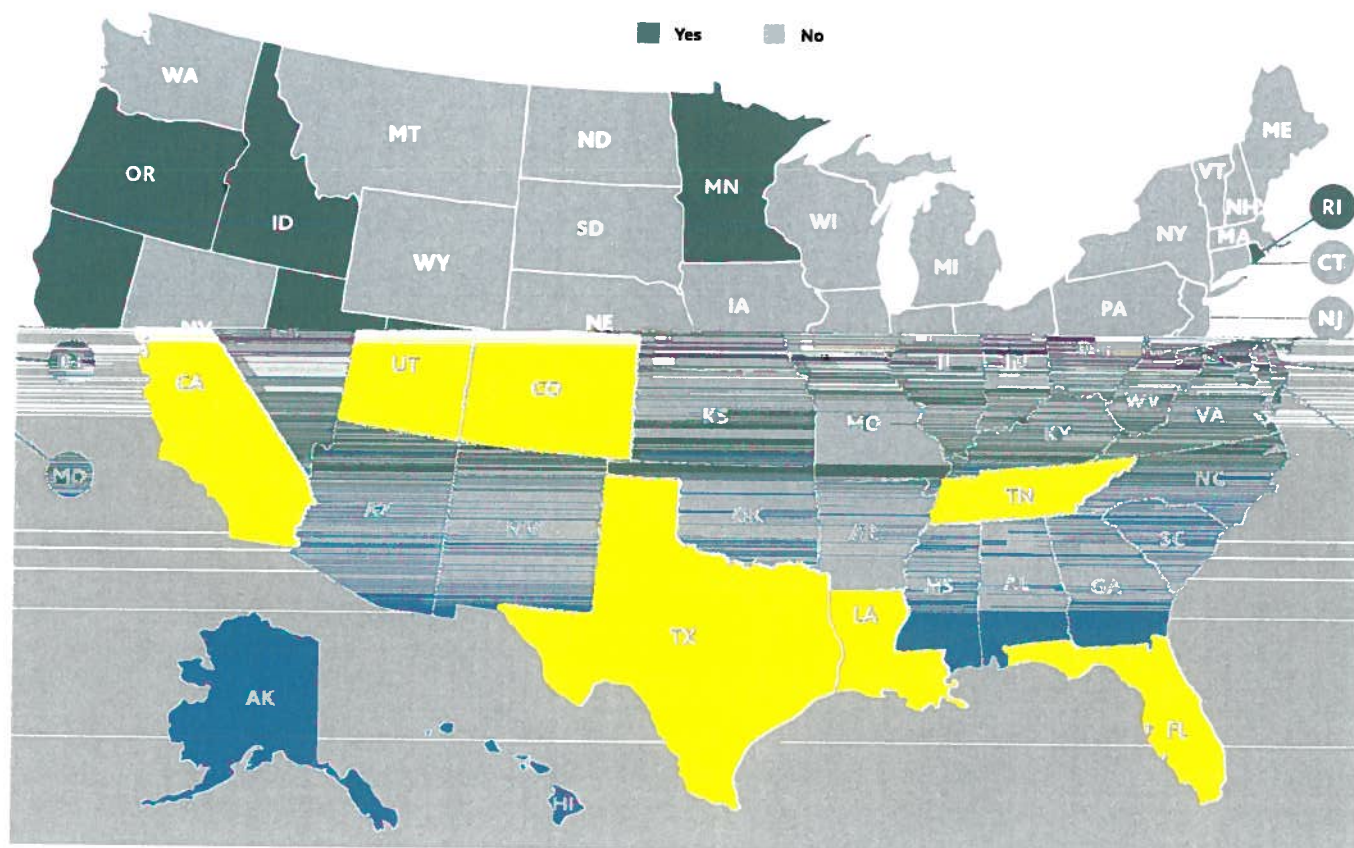
Source: Moody's Investors Service

(4) GO debt secured by statute or judicial ruling

A state's intent to secure GO debt service payments through a statute or a judicial ruling is another key security feature of GO debt. While the language of the statute need not use the word "lien", it must otherwise be unambiguous as to intent. For example, the statute can refer to "security interest" or "perfection" to demonstrate that the state intends for the pledge to be secured, whether or not the local government takes affirmative steps to create a lien. As Exhibit 5 illustrates, we identify only 11 states that either have statutory language securing a GO pledge, or in which a court decision has meaningfully shifted our view of the pledge as being secured.

Exhibit 5

Eleven States Demonstrate a GO Pledge Secured by Statute or Through Court Case



CA- See following discussion

CO- Colo. Rev. Stat. §11-57-208

FL - Fla. State Ann. 132.43. Lien applies to bonds issued under Florida's Advanced Refunding Law and where an escrow is established.

ID - Title 57, Chapter 2, Section 234 of Idaho Code

LA - La. Rev. Stat. Ann. §39:1430.1

OR- Or. Rev. Stat. §287A.310

RI - R.I. Gen. Laws §45-12-1

TN- Tenn. Code Ann. § 9-22-104

TX - TX Govt. Code Title 9, Subtitle A, Chapters 1202.001 and 1208.002

UT- Utah Code §11-14-501

Source: Moody's Investors Service

Whether a pledge is secured or unsecured should have a meaningful impact on the expected loss of GO debt because it bolsters the debtor's claim in the negotiations within a bankruptcy proceeding. This is especially true in the 28 states that allow their local governments to file for bankruptcy under Chapter 9. In bankruptcy, there are two basic debt classifications – secured and unsecured. Secured debt has a higher degree of protection than unsecured debt. In general, secured creditors are entitled to receive payment in full up to the value of their claim, as long as the value of the property that is securing the claim is equal to or more than the claim itself. If the value of the property securing the debt is less than the value of the claim, the difference is treated as an unsecured claim. Absent a lien or collateral pledge, bankruptcy law treats GO debt as unsecured.

Under federal bankruptcy law, in a reorganization unsecured bondholders will have to compete with other unsecured creditors and may not be paid in full because the revenue or property available to them is what is left over after secured creditors and certain other creditors are paid.

The scarcity of local government bankruptcies with GO debt means that there are few court tests of the GO pledge. The presence of a state statute governing security should have substantial weight in the adjudication of a Chapter 9 filing. An example of this is the [Central Falls, RI](#) (Ba3 stable) bankruptcy, where the state enacted an emergency statute clearly designed to protect GO debt in bankruptcy. Not only did bankruptcy court confirm the plan that did not impair GO bondholders, no impaired creditor challenged the decision.

While California does not have a specific lien statute, we include it with the ten that do based on the outcome for GOULT bondholders in the [Sierra Kings Health Care District, CA](#) (Baa3) bankruptcy. The district declared bankruptcy in 2009 after bondholders demanded an immediate acceleration of payment on the bonds because of alleged covenant violations, even though the district remained current on all of its revenue and GO debt.

Despite the bankruptcy filing, Sierra Kings GOULT investors never stopped receiving debt service payments. The court later ratified an agreement between the bondholders and the district allowing the bondholder to continue to receive debt service and not take a loss. The parties agreed that the debt service payments represented special revenues, another form of secured status under the bankruptcy code exclusively for certain types of municipal debt. Additionally, while it was not mentioned in the decision, California's lockbox feature may have played a role in the decision.

In contrast to the Sierra Kings case, investors in Detroit GOULT debt experienced payment defaults and losses during the city's Chapter 9 bankruptcy. GOULT investors eventually settled with the city after litigating the issue of whether the GOULT pledge was a secured claim. The settlement was around a 74% recovery. Detroit's GOULT debt had a full faith and credit pledge as well as a dedicated property tax levy, but lacked a lockbox or a state statute conferring secured status. The settlement demonstrates the limitations of the GOULT pledge in bankruptcy, particularly given the absence of the latter two features, but the empirical evidence remains thin. Given the absence of other tests, and the broad uncertainty within bankruptcy itself, it is impossible to assert what effect statute and lockbox features would have had on the final outcome.

Secured by statute versus a statutory lien

We have identified 10 states with statutes that may qualify GO debt as statutory liens under the bankruptcy code. A statutory lien is a particular type of lien the bankruptcy code recognizes that provides secured status to creditors. We previously identified a smaller group of states as having statutory liens under a more restrictive definition. Given so few legal decisions on the issue, we believe the better approach is to identify those states that explicitly secure the GO pledge. Until the precise nature of the pledges in the other states are worked out in the courts, bondholders' status as secured or unsecured will remain uncertain.

Variations in GO pledges have implications for ratings

Limitations of legal pledges

The underlying legal pledge is but one factor in the assignment of a GO rating, and alone is not determinative of credit quality. An issuer's fundamental credit strength is a far broader consideration in our analysis, and necessarily reflects many factors. These include the health and diversity of the tax and economic base; revenue structure that may either enhance or hinder the ability to increase income; flexibility to manage operating expenses; overall financial management; and the level of debt and other fixed costs. Within these general categories are other critical factors that can have an impact on ratings.

As illustrated most recently in the Detroit and Jefferson County bankruptcies and the Harrisburg restructuring, a local government's GO pledge is not a guarantee against default and principal impairment ([we have already noted that Detroit's revenue-bond investors fared better than GOULT or GOLT investors](#)). In both the Detroit and Stockton cases, retiree pensions received significantly better recoveries than bondholders.

A government's ability to repay its debt goes hand-in-hand with its ability to provide essential public services and remain in financial balance. A government that cannot carry out its services and remain solvent will likely eventually default on its debt, regardless of the underlying legal pledge. This concept has necessarily informed our perspective when considering the significance of the different attributes of GO pledges across US local governments.

Rating implications

Given that the GO pledge is a broad promise, and recognizing the limitations of the pledge as one of several credit factors, we view the four main features found in local government GO pledges as relatively marginal potential differentiators of credit strength. Two of the four features should provide more meaningful credit strength once in bankruptcy: the separation of funds through a lockbox, and the statutory provisions for secured status. Neither of these features together or alone can prevent credit deterioration in the first place, nor do they preclude a bankruptcy or ultimate monetary default. They may, however, enhance recovery prospects compared to other debt and forestall any "stay" on debt payments once in bankruptcy, but bankruptcy itself falls within our formal definition of default.

The other two features—the presence of the "full faith and credit" promise, and a separate debt service levy—we believe contribute no additional strength beyond the basic GOULT promise either before or within bankruptcy.

Thus, for GOULT pledges:

- » We provide a modest one-half notch uplift to GOULT pledges that are either secured by statute or have a lockbox feature.
- » We provide a full notch uplift to GOULT pledges that feature both the statutory protection and the lockbox. This full notch generally applies only to Colorado school districts and California cities (only by agreement) and school and other special districts.

Exhibit 6

States With a Lockbox Structure and Secure GOULT Pledges by Statute

Secured by Statute and Lockbox	Secured by Statute Only*	Lockbox Only***
CA (cities, schools)	CA (counties)**	AZ (schools only)
CO (schools)	CO (cities, counties)	SC (schools only)
	ID	WA (schools only)
	LA	
	MN	
	OR	
	RI	
	TN	
	TX	
	UT	

*Florida's statute is for GO bonds secured by an escrow and is therefore not included in the list above. Chicago Public Schools, IL, is governed by separate statutes and GO Alt Rev debt is secured by statute. All other school district debt in Illinois is not secured so therefore Illinois schools are excluded from this list.

** For CA cities, only those that contract with their county to pay debt service on their behalf receive credit.

*** MS school districts may have lockbox structure per instructions to local tax collector, but this is not required or common. If present, additional uplift may be given.

Source: Moody's Investors Service

As indicated in our GO methodology, we evaluate GOLT bonds in the same manner as GOULT debt, but we may notch credits with a GOLT pledge downward to reflect the limitation on raising taxes. We do not notch downwards automatically for an GOLT pledge, however. Although "limited tax" implies narrower and more limited security, whether notching is warranted depends on the parameters of the tax limitation. For example, a municipality may still be able to raise taxes within the overall limits set by a state, or it may be able to override these limits. We may limit or even eliminate downward notching for GOLT pledges that benefit from a lockbox and/or being secured by a state statute.

Michigan

Despite Strong Statutory Protections for Local Government GO Bonds in Michigan, Issuers Still Default

There are two types of GO bonds in [Michigan](#) (Aa2 positive), the GOULT and GOLT. The GOULT pledge is stronger because it carries the issuer's promise to levy and collect ad valorem taxes on all taxable property, without limitation as to rate or amount to pay principal and interest when due. Tax collections for GOULTs are exclusively dedicated to support debt service on the associated bonds. The GOLT pledge is the weaker of the two as the issuer's promise to levy and collect ad valorem taxes is subject to constitutional and statutory limitations, though does typically benefit from the issuer's full faith and credit pledge, as well. Property taxes that are collected are also designated for operations, resulting in competition between debt service expenditures and providing core services to residents. The table below highlights the characteristics of both forms of GO debt in more detail:

Michigan General Obligation Pledge Cities, Counties and School Districts

Limited Tax and/or Unlimited Tax	GOULT	GOLT
Separate levy dedicated to debt service	Yes	No
Pledged revenues held separately for benefit of bondholders (lockbox)	No	No
Full faith and credit	Yes	Yes
Secured through statute	No	No
Authorized for bankruptcy protection	Conditional/Limited	Conditional/Limited

Detroit and Two School Districts Test the Strength of GO Bond Pledges

Despite the strength of the GOULT pledge and to a lesser extent the GOLT pledge, the city of Detroit defaulted on both securities, with creditors receiving an estimated recovery rate of 74% and 34%, respectively. Treatment of the city's GOULT and GOLT bonds undermines the perceived strength of Michigan's GO pledge given its impairment in Chapter 9.

[Pontiac School District](#) (Caa1 stable) defaulted on GOLT debt and Buena Vista School District (unrated) defaulted on GOULT debt. Cash flow shortfalls and the withholding of state aid were the primary drivers of the defaults. In both cases, bond insurance covered bondholder losses. Pontiac repaid the bond insurer.